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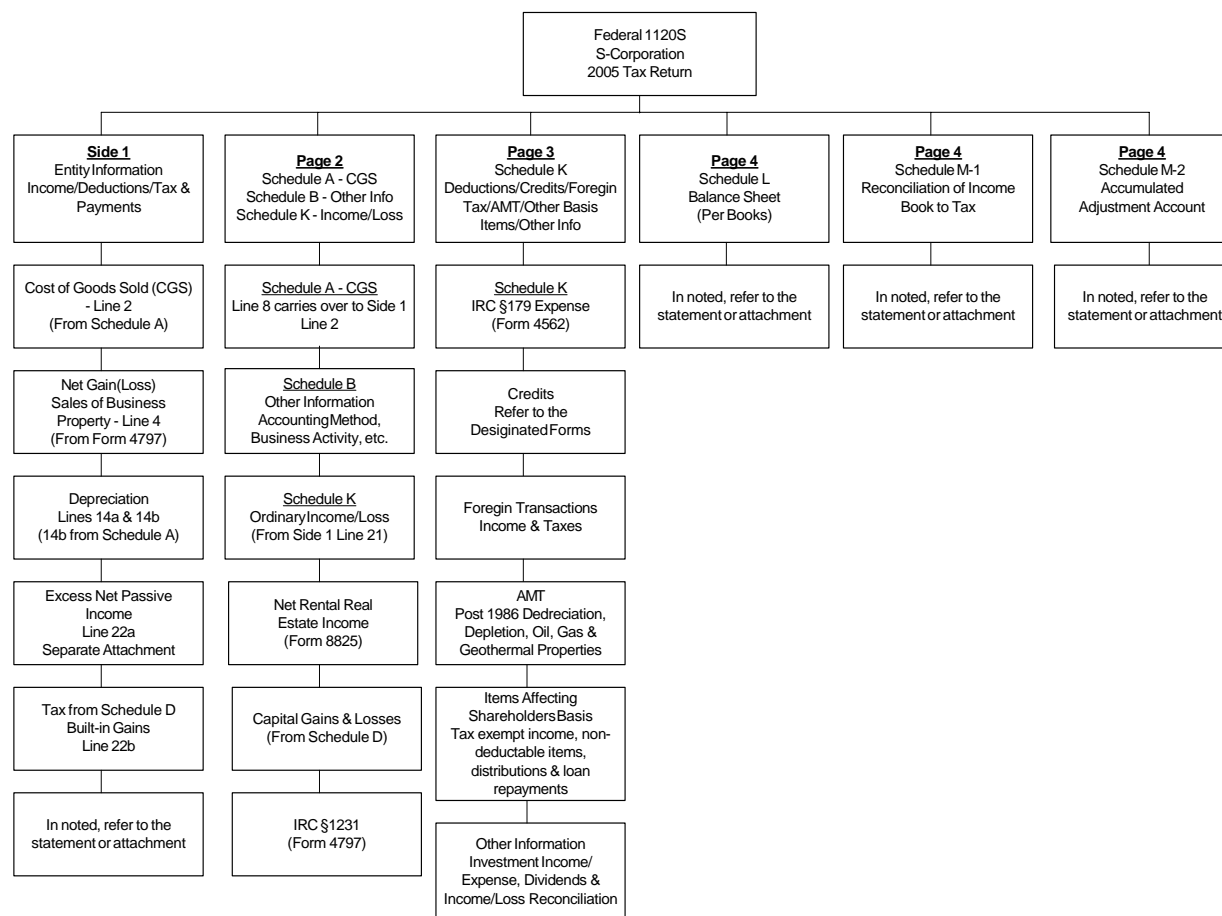
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1.1 DIAGRAM OF FEDERAL 1120S



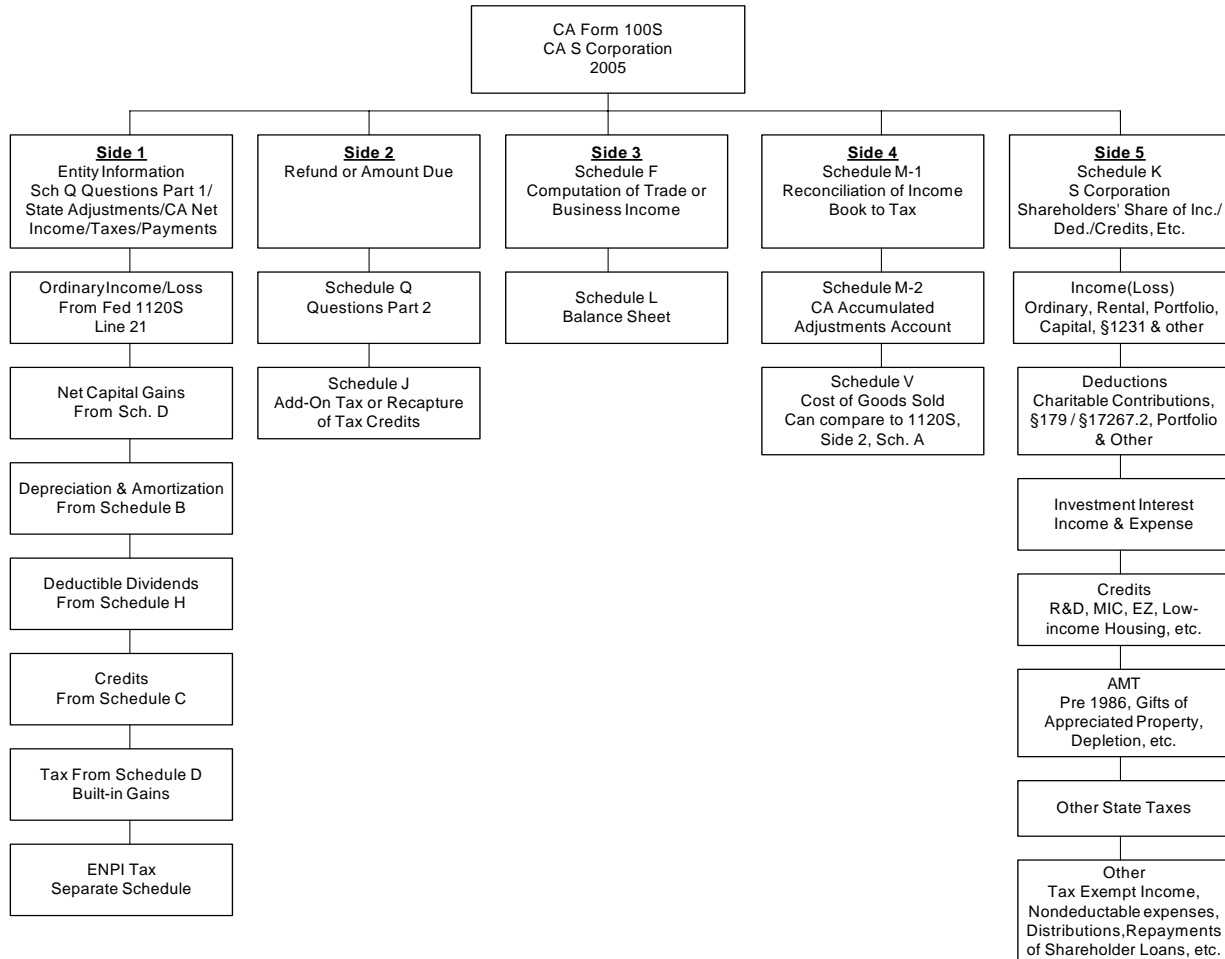
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1.2 DIAGRAM OF CALIFORNIA 100S



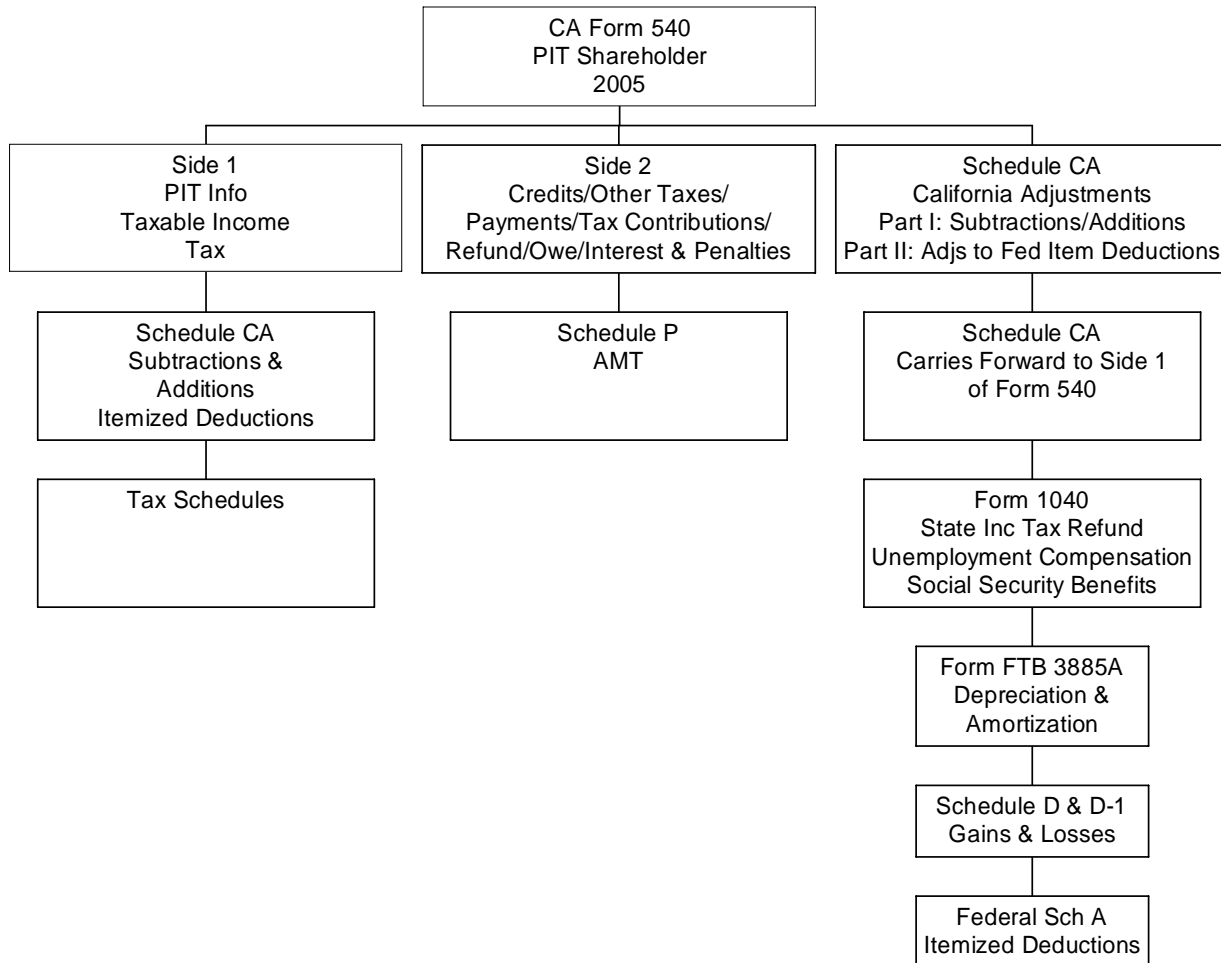
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1.3 DIAGRAM OF CALIFORNIA 540



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Page 5 of 19**1.4 GLOSSARY OF TERMS**

The following list includes typical S-Corporation terms:

TERM	MEANING
AAA	Accumulated Adjustments Account
BIG or BIG's	Built-in Gains
BIL or BIL's	Built-in Losses
COD	Cancellation of Debt
CODI	Cancellation of Debt Income
C/G	Capital Gain
C/L	Capital Loss
CGS or COGS	Cost of Goods Sold
E&P	Earnings & Profits
ENPI	Excessive Net Passive Income
ESBT	Electing Small Business Trust
FEIN	Federal Employer Identification Number
FIFO	First-In, First-Out
C Corporation or C Corp.	General C Corporation
GM	Gross Margin
GP	Gross Profit
LIFO	Last-In, First-Out
MIC	Manufacturers' Investment Credit
NI	Net Income
NOL	Net Operating Loss
NPI	Net Passive Income
OAA	Other Adjustments Account
PTI	Pass Through Income
PTTP	Post Termination Transition Period
QSub	Qualified Subchapter S Subsidiary
QSST	Qualified Subchapter S Trust
R&D Credit	Research and Development Credit
S/H or SHD	Shareholder
SS# or SSN	Social Security Number
SA or S/A	State Adjustments
S-Corporation or S Corp.	Subchapter S-Corporation

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1.5 CALIFORNIA 100S

When scoping California Form 100S, Federal 1120S, and California Form 540, consider the materiality of audit issues. Also, consider the shareholders' tax consequences of the adjustments made at the corporate level.

When scoping the California Form 100S, consider the following issues:

- 1.5.1 Form 100S: Questions - Side 1
- 1.5.2 Form 100S: Side 1
- 1.5.3 Form 100S: Schedule F Computation of Trade or Business Income
- 1.5.4 Form 100S: Schedule V Cost of Goods Sold
- 1.5.5 Form 100S: Schedule J Add-On Taxes or Recapture of Tax Credits
- 1.5.6 Form 100S: Questions Side 2
- 1.5.7 Form 100S: Schedule K
- 1.5.8 Form 100S: Schedule L Balance Sheet
- 1.5.9 Form 100S: Schedule M-1
- 1.5.10 Form 100S: Schedule M-2
- 1.5.11 California Schedule K-1 (100S)

1.5.1 Form 100S: Schedule Q Questions- Side 1

Form Item	
"Question" on Form 100S page 1	Question A – A check in any of these boxes indicates that this is the Corporation's final return. Did the corporation merge or reorganize with another entity? If yes, look for the merger/reorganization information attached to the return.

1.5.2 Form 100S: Side 1

Form Item	
Line 1 – Ordinary Income	Trace the amount to Form 100S, Schedule F, line 22 as well as to the federal Form 1120S, Line 21

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Line 2 - Foreign or domestic tax	This tax add-back amount may be traced back to Form 100S, Sch. F, Line 12. Form 100S, Sch. F, line 12 often includes other tax items. Look for a statement detailing the tax reported on Form 100S, line 12 in the return.
Line 4 - Net Capital Gain	Trace the amount to Form 100S, Schedule D. Look for a statement detailing any net amounts.
Line 6 - Portfolio Income	If this is a material amount and the corporation reports C corporation earnings and profits, the excess net passive income issue may exist. The ENPI tax is reported on Form 100S, line 29. Various types of portfolio income are reported on Form 100S, Sch. K, lines 4a-4f.
Line 7 - Other Additions	If amounts are material, find out what they are.
Line 9 - Dividends	Refer to Sch. H for details of the dividends reported.
Line 11 - Contributions	The contributions deduction is limited. Refer to Form 100S Instructions.
Line 13 - Other Deductions	Look for a statement detailing the items of deductions.
Line 17 - R&TC §23802(e) deduction	The amount of ENPI or BIG is deducted here to compute net income for 1.5% tax purposes.
Line 18 ~ 20 - Carryovers	Trace back to prior years.
Line 23~26 - Tax Credits	See Sch. C and California forms filed for respective credits.
Line 28 - Tax from Sch. D	The BIG tax, if any, should be reported here.
Line 29 - Excessive Net Passive Income Tax	The ENPI tax, if any, should be reported here.

1.5.3 Form 100S: Schedule F Computation of Trade or Business Income

Form Item	
Line 1a – Gross Receipts	
Line 2 - Cost of Goods	This line sources from Form 100S, Schedule V

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Sold	Cost of Goods Sold, line 8.
Line 4 – Net Gain	This amount sources from Form 100S, Schedule D, Section B, Part II, line 10.
Line 5 - Other Income	Look for a statement explaining the income. Be aware that ENPI or BIG issues may be present.
Line 12 - Taxes	Look for a statement explaining the types of taxes. Certain taxes deducted here must be added back on Form 100S, Side 1, line 2.
Line 20 - Other Deductions	Look for a statement explaining the deductions. Are they reasonable?
Line 22 - Ordinary Inc/Loss	This amount should be carried over to Form 100S, Side 1, line 1.

1.5.4 Form 100S: Schedule V Cost of Goods Sold

The amount on Form 100S, Schedule V, line 8 should be carried over to Form 100S, Schedule F, line 2.

1.5.5 Form 100S: Schedule J Add-On Taxes or Recapture of Tax Credits

This Schedule reports additional taxes & recapture of certain items

1.5.6 Form 100S: Questions Side 2

Form Item	
"Question" on Form 100S page 2 (Cont. from page 1)	<p>Question B - If the "yes" box was checked, find out why.</p> <p>Question C - To find out the S-Corporation's business activity, look up the business activity code in California Package X, 100S instructions for Question C.</p> <p>Question E - To find out if the tax return</p>

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	<p>includes Qualified Subchapter S Subsidiaries.</p> <p>Question F - This date may be useful in scoping for issues arising from the corporation's S election. Examples are BIG, ENPI, and other issues relating to the S-Corporation's maintaining C-Corp E&P.</p> <p>Question H – See Question F explanation above.</p> <p>Question I - If the "yes" box is checked, consider obtaining a copy of the Revenue Agent's Report if not provided with the return.</p> <p>Question J - This date may be important for BIG and ENPI purposes. Caution this date may not be reliable. Look for California Form 3560 in the Corp folder for accuracy.</p> <p>Question O - If "no" is checked, consider finding what wasn't filed.</p> <p>Question Q – To find out if the corporation included a Reportable Transaction, Listed Transaction or Registered Tax Shelter in the tax return.</p> <p>Special Note - Tax preparers sometimes place disclaimers on the returns.</p>
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1.5.7 Form 100S: Schedule K

Form Item	The items presented on this schedule are items that are to be allocated among the shareholder(s).
Column b - Amount from Federal Sch K	The items reported in this column should be the items reported on the federal Form 1120S, Sch. K.

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Column c - California Adjustment	California adjustments can be traced to other attached schedules.
Line 1 - Ordinary Income/Loss	This amount can be found on federal Form 1120S, Sch. K, line 1; California Form 100S, Sch. F, line 22; and California Form 100S, Side 1, line 1.
Line 4d - Net Short-Term Capital Gain/Loss Line 4e, Net Long-Term Capital Gain/Loss	Refer to California Form 100S, Sch. D and California Schedule D-1 for details.
Line 4f - Other Portfolio Income	Refer to detailed attachments/statements. If the S-Corporation has C Corporation earnings & profits and reports a large portfolio income, there may be an ENPI issue. The ENPI tax should be reported on Form 100S, Side 1, line 29.
Line 5 - IRC Section 1231 Net Gain/Loss	Look for potential BIG or BIL issues. The amount of IRC Section 1231 gain/loss traces back to California Form 100S, Sch. D, Section B, Part II, line 5 and to California Schedule D-1, Part I, line 9.
Line 6 - Other Income	Look for a schedule or statement detailing the other income.
Line 7 - Charitable Contributions	The amount of charitable contributions deductions for an S-Corporation is limited to 10% of California Net Income without regard to charitable contributions and special deductions. If an appreciated property was contributed, there may be an AMT issue at the shareholder level.
Line 10 - Other Deductions	Review the schedule/statement detailing the deductions. If deductions are material, consider requesting explanations during the examination.
Line 13 - Other Credits	Scope appropriate California forms used to compute credits.
Line 14a ~ 14f - Adjustments & Tax Preference Items	Include these items in computing shareholder AMT. For more detail, refer to the federal 1120S instructions for Sch. K.
Line 15 - Other State Taxes	Sometime S-Corporations attach copies of the other states' tax returns to the California Form

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	100S.
Line 16 - IRC Section 59(e) Election Expenditure	If the amount is material, verify the application of IRC section 59.
Line 17~18 - Tax Exempt Interest Income & Other Tax Exempt Income	See S Corp Chapter 9.0 (Shareholder Basis) and S-Corp Chapter 8.0 (Distribution/AAA) of this manual.
Line 19 - Nondeductible Expenses	The amount reported on this reduces shareholder basis.
Line 20 - Total Property Distributions	This amount should equal the aggregate amount of distributions reported on line 21 of Sch. K-1's of Form 100S and the amount reported on line 7(a) of Sch. M-2 of Form 100S. If there is a discrepancy, consider requesting detailed explanation.
Line 21 - Other Items	Review the attached schedule/statement.
Line 22 - Total Dividend Distributions	If an amount is reported, scope the shareholder's federal personal income tax return, Form 1040, Sch. B, for the dividend income.

1.5.8 Form 100S: Schedule L Balance Sheet

Form Item	The balance sheet items help to identify transactions incurred during the year.
Line 2 - Receivables	Find out the corporation's primary business to understand the types of receivables included in the account.
Line 3 - Inventories	Find out the corporation's primary business to understand what costs were capitalized in the account.
Line 5 - Other Current Assets	Review schedules/statements attached.
Line 6 - Loans to Shareholders	Are these bona-fide loans or disguised distributions? Did the corporation report any interest earned on loans made to shareholders?
Line 8 - Other	Look for statements explaining other

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Investments	investments.
Line 9 - Buildings & Other Fixed Depreciable Assets	Look for schedules/statements (such as a depreciation schedule) explaining tangible depreciable assets. Note any increase or decrease in the account. Taxable transactions may be associated with the changes in the account.
Line 10 - Depletable Assets	Look for schedules/statements explaining depletable assets. Do these assets lead to any depletion expenses? Oil wells?
Line 12 - Intangible Assets	Look for schedules/statements explaining intangible assets.
Line 13 - Other Assets	Look for schedules/statements explaining other assets.
Line 18 - Loans from Shareholders	Look for schedules/statements for details. If any portion of loans were repaid, there may be a taxable loan repayment issue at the shareholder level. See S Corp 090000 for details.
Line 19 - Mortgages/Notes/Bonds ≥ 1 yr	Sometimes loans from shareholders are reported here.
Line 20 - Other Liabilities	Sometimes loans from shareholders are reported here.
Line 21 - Capital Stock	This item is generally reported consistently from year to year. If there are any changes between taxable years, there may be changes in the ownership of the corporation.
Line 22 - Paid-In Capital Surplus	This amount represents the amount of additional capital contributions from shareholders. The amount of loans from shareholders may be reclassified to PICS here.

1.5.9 Form 100S: Schedule M-1

Sch. M-1 reconciles the corporation's book income to its taxable income. Analyze the reconciliation to ensure proper reporting of Sch. M-1 items. A statement explaining each Sch. M-1 item may help you identifying tax issues.

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Form Item	
Line 1 - Net Income Per Books	This number is the corporation's book income.
Line 8 - Income/Loss	This number is the corporation's taxable income and is carried forward to Form 100S, Side 1, line 15.

1.5.10 Form 100S: Schedule M-2

Sch. M-2 reports the changes in the corporation's retained earnings during the year.

Form Item	
Column (a), Line 1a - Balance at the beginning of the year	The initial AAA balance is zero. The corporation reports the running balance of the account every year, carrying the previous year's ending balance over to the current year.
Column (a), Line 2a - Ordinary Income	This amount is the income reported on Form 100S, Side 1, line 1.
Column (a), Line 3a - Other Additions	This amount includes all income/gains including California positive adjustments, except for ordinary income reported on line 2a above.
Column (a), Line 4a - Loss from Side 1, line 1	This amount is the loss reported on Form 100S, Side 1, line 1.
Column (a), Line 5a - Other Reductions	This amount includes all loss/deduction items including California negative adjustments, except for ordinary loss reported on line 4a above.
Column (a), Line 7 - Distributions Other than Dividend Distributions	This amount is the amount of distributions from the S Corp's earnings (after tax). This amount must not create a negative AAA balance. Therefore, the amount entered here may be a plug-in figure and may not be the actual amount of distributions. Compare this amount with the amount reported on California Form 100S, Sch. K, line 20.
Column (b), Lines 1, 3,	Only S-Corporations that have Accumulated E&P

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5~8	at year-end maintain this column. The account is used for tax-exempt income (& related expenses) of the S-Corporation.
"Box" - Regarding C Corporation E&P	This box should be checked if the S-Corporation retains C-Corp E&P. Consider verifying the amount reported here.

1.5.11 Form 100S: Schedule M-2

This schedule is used to present each shareholder's pro rata share of flow-through gains/losses from the S-Corporation.

Schedule Item	
Shareholder's Identifying Number	Usually the shareholder's social security number.
California Corporation Number	S-Corporation's California corporation number (7 digits).
A: Shareholder's percentage of stock ownership	Percentage of the shareholder's interest in the S-Corporation at the end of year.
C: Check boxes if applicable: Final K-1; Amended K-1	<p>The final K-1 means the final K-1 for a terminating S-Corporation or the final K-1 for the departing shareholder (the shareholder has sold or redeemed his/her interest).</p> <p>If this is an amended K-1, consider verifying what items were amended and whether the shareholder filed an amended return.</p>
E: Nonresident shareholders	If the "yes" box is checked, review column (e) and the shareholder's Form 540NR filed with the FTB. Did the shareholder report his/her share of California source income in California?
The Columns: (a) Pro Rata Share Items, (b) Amount from Federal Sch. K-1, (c) CA adjustment, (d) CA amount, (e) CA source	Sch. K-1 should reflect all items reported on Sch. K, allocated by the ownership percentage.

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amounts and credits	
Lines 17~18 – Tax Exempt Interest Income & Other Tax Exempt Income	This amount increases shareholder basis.
Line 19 – Nondeductible Expenses	This amount reduces shareholder basis.
Line 20 – Total Dividend Distributions paid from Accumulated E&P	The California Sch. K-1, line 20 reports, "total dividend distribution paid from accumulated earnings and profits." The shareholder must report the dividend income in his federal Form 1040, Sch. B.
Line 21 – Property Distributions (including cash) other than dividend distributions.	The aggregate of Sch. K-1, line 21 must equal the amount reported on Sch. K, line 20.
Line 22 – Loan Repayments	If an amount is reported here, estimate the shareholder stock and debt basis for a possible taxable loan repayment issue.
Line 23 - Supplemental Information	This area is often used to disclose additional information.

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1.6 FEDERAL FORM 1120S: U.S. INCOME TAX RETURN FOR AN S-CORPORATION

- 1.6.1 Federal Form 1120S: Side 1 and Side 2
- 1.6.2 Federal Form 1120S: Schedule K-Shareholder's Shares Of Income, Credits, Deductions, Etc.
- 1.6.3 Federal Form 1120S: Schedules L, M-1, & M-2
- 1.6.4 Federal Form 1120S: Schedule K-1

1.6.1 Federal Form 1120S: Side 1 and Side 2

Note: Federal Form 1120S, Side 1 is similar to California Form 100S, Sch. F (Computation of Trade or Business Income). Because of the California's 1.5% entity-level tax, the front page of California Form 100S, Side 1 contains separately stated items reported on Sch. K, but federal Form 1120S does not.

Form Item	
A: Date of election as an S-Corporation	This date should be the date reported on California Form 100S, Side 2, Question J (Effective date of federal S election).
B: Business Code	The code is similar to the code reported on California Form 100S, Side 2, Question C (Principal Business Activity Code).
C: Employer Identification Number	This is the FEIN. California Form 100S, Side 1 also contains the FEIN.
D: Date Incorporated	This date should be the date reported on California Form 100S, Side 2, Question F (Date Incorporated)
E: Total Assets	This amount can be reconciled with the federal & California Sch. L.
F: Check Applicable Boxes	If any of these boxes are checked, consider examining any issues associated with the box checked.
Line 1-21	These items should be consistent with items reported in California Form 100S, Sch. F.
Schedule A-Cost of Goods Sold	This schedule should be consistent with California Form 100S, Sch. V, Side 4.

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Schedule B-Other Information	Compare the information with the information reported on California Form 100S, Questions E ~ Q for consistency.
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1.6.2 Federal Form 1120S: Schedule K-Shareholder's Shares Of Income, Credits, Deductions, Etc.

Federal Form 1120S, Sch. K should be consistent with California Form 100S, Sch. K.

1.6.3 Federal Form 1120S: Schedules L, M-1, & M-2

These schedules are similar to California Schedules L, M-1 & M-2.

1.6.4 Federal Form 1120S: Schedule K-1

This schedule is similar to California Sch. K-1. Federal Sch. K-1, column (b) is comparable with California Sch. K-1, column (b). To find out what adjustments were made for California purposes, see California Sch. K-1, column (c).

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Each flow-through item on federal Sch. K-1 Part III or in California Sch. K-1, column (b) should be reported using the appropriate federal Form 1040 schedule. Then, each flow-through item should be adjusted by the amount of California (positive/negative) adjustment reported on California Sch. K-1, column (c), to convert the federal amount to the California amount. These adjustments are made on California Schedule CA (540).

Federal Form 1040	California Sch. K-1, column (b)
Schedule E: Part I - Income from Rentals & Royalties Part II - Income or Loss From Partnerships & S- Corporations	Line 1 Ordinary Business Income (Loss), Line 2 Net Rental Real Estate Income (Loss) and Line 3 Other Net Rental Income (Loss) flow through to Sch. E.
Schedule B: Part I-Interest Income Part II-Dividend Income	Generally, Lines 4a Portfolio Interest Income (Loss) and 4b Portfolio Dividend Income (Loss) flow through to this schedule.
Form 1040, Line 21 - Other Income	Line 4f – Other portfolio income (loss), and line 6, Other income, may be reported here. Also, if taxable loan repayments exist "Loans from Shareholders" (California Sch. K-1, line 22), the taxable amount may be reported here or on Schedule E.
Schedule D Capital Gains (Losses)	Lines 4d Net Short Term Capital Gain (Loss) and line 4e Net Long Term Capital Gain (Loss) flow through to this schedule. Line 5 – Net Gain (Loss) IRC §1231 may also be reported on Sch. D.
Schedule A Itemized Deductions	Line 7a Charitable Contributions flow through to Sch. A, Gifts to Charity – Line 15 for Cash Contributions and Line 16 for Non-Cash

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	Contributions. Line 11, investment interest flows through to Sch. A, line 13.
Federal Form 6251 Alternative Minimum Tax	Lines 14a-14e – Adjustments and Tax Preference Items.

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